Effects Unique to Small Business

Incentive Effects. OBRA-93 includes provisions that encourage investment and employment in small businesses. The most significant of these provisions increases from $10,000 to $17,500 the amount of investment that taxpayers with annual investments of less than $200,000 can deduct immediately (or "expense"). A related provision increases this amount to $37,500 for small business investing in "empowerment zones" (economically distressed localities). Other provisions that favor small businesses are the rollover of the gain from the sale of publicly traded securities into specialized small business investment companies, the 50 percent exclusion of capital gains income on small business stock held for more than five years, and extension of tax-exempt borrowing in the form of qualified small issue bonds. Finally, OBRA-93 helps some small businesses by extending the health insurance deduction for self-employed persons.

Tax Burden on Small Business Owners. The increases in marginal income tax rates in OBRA-93 and the removal of the Hospital Insurance cap do reduce the after-tax income of small business persons with the highest incomes. But the tax rate increases equally affect other high-income people who work for large corporations and nonprofit organizations, and the income tax rate increases equally affect other high-income people who invest in corporate equity and bonds. Therefore, the tax rate increases will not increase the relative cost of either labor or capital to small business and will not place small businesses at a disadvantage in relation to large corporations.

Although the tax rate increases affect the highest income taxpayers and many high-income people run their own businesses, most small business people do not face higher marginal tax rates under OBRA-93. Most of those who do face higher marginal tax rates under OBRA-93 do not receive the majority of their income from small business.

For the purpose of this analysis, CBO defines a small business person as anyone who files a sole proprietorship, partnership, or Subchapter S corporation tax return. This category includes taxpayers in many different occupations and industries--small retailers, painting contractors, investment bankers, doctors, and lawyers. It also includes employees of large organizations who have financial interests in one or more partnerships.

One measure of the way in which OBRA-93 affects small business people is the percentage who pay higher taxes. Using 1990 Statistics of Income data, CBO estimates 14 million tax returns will report positive business income in 1994. Of those returns, 700,000 will have taxable income above $140,000 for joint returns (or $115,000 for single returns)--the threshold for the 36 percent tax rate. About 40 percent of those 700,000 returns will have income above $250,000--the threshold for the 39.6 percent tax rate. Thus, recent data indicate that about 5 percent of the returns reporting positive business income will face higher statutory marginal tax rates under OBRA-93. Limiting the definition of a small business person to include only those taxpayers who report more business income than wages, CBO estimates that out of about 7 million returns in this group, 350,000 (about 5 percent) would have income subject to the 36 percent tax rate, and 150,000 (about 2 percent) would have income subject to the 39.6 percent tax rate.

Although the tax rate increases affect relatively few small business people by either definition, many of the taxpayers affected by the higher rates report some small business income. CBO estimates (again from the 1990 Statistics of Income data) that slightly more than half of the tax returns that are subject to the higher marginal tax rates will include some positive business income in 1994. For about half of these, however, small business income represents a relatively small fraction of total taxable income. Returns reporting more business income than wages amount to 28 percent of all returns affected by the higher marginal tax rates.

The removal of the HI cap also affects top earners. Before OBRA-93, only earnings below a threshold were subject to HI taxes. OBRA-93 extends the HI tax to earnings over the threshold--estimated to be $141,900 in 1994. Of the 14 million self-employed persons paying HI taxes in 1994, approximately 150,000 will pay higher HI taxes because of OBRA-93.[18]

Other Effects on Business Incentives

International Provisions. Three provisions in OBRA-93 cut back on the preferential treatment of certain types of income from international transactions. First, the oil and gas and shipping industries now must consider their foreign investment income from working capital to be passive income, just like similar income in other industries. Second, controlled foreign corporations no longer receive deferral from current U.S. tax for some forms of income. Third, exports of certain unprocessed softwood timber no longer qualify for

18. Not all small business persons, as defined above, remit HI taxes in the same way. Sole proprietors and partnerships pay HI taxes on their covered earnings through self-employment (SECA) taxes. Owners of S corporations have HI taxes withheld as FICA taxes on the covered portion of wages they receive. Because it is not possible to isolate the wages of S corporation filers from all other wages, the data that CBO reports on higher HI taxes of small business owners omit those who receive wages from S corporations.

preferential tax treatment. These three provisions discourage selected transactions, but will have little effect on most foreign investments of U.S. corporations.

Denial of Deductibility for Certain Business Expenses. OBRA-93 limits or denies deductions for certain business expenses, including business meals and entertainment, club dues, some executive pay, and lobbying. The reduction in the deductible portion of business meals and entertainment from 80 percent to 50 percent raises most of the revenue from this group of provisions.

The rationale for limiting deductions for business meals and entertainment is that a portion of these costs represents noncash consumption to some employees and self-employed people instead of necessary costs of production. If these outlays substitute for higher cash wages, they represent income to employees. In these cases, denying deductions is a simpler way of including this consumption in the tax base than counting the value of meals and entertainment as employee income. By contrast, the rationale on tax neutrality grounds for denying deductions for expenses of lobbying and compensation of highly paid executives is less apparent. For these activities, one can view denial of deductibility as equivalent to an excise tax on activities that the Congress wishes to discourage.

The limitation of deductibility for business meals and entertainment could reduce business spending on these activities, but it is difficult to know how much. Reducing the tax-free share of these expenditures raises their cost to businesses, but the increase in marginal tax rates offsets this in part by increasing the value of all tax-free activities. Taking these offsetting effects into account, a recent Congressional Research Service study suggests that OBRA-93 will not adversely affect the restaurant and entertainment industries.[19]

Tax Increases on Specific Industries and Transactions. Several provisions in OBRA-93 increase taxes either on corporations in specific industries, such as domestic securities dealers or U.S. manufacturing firms that operate in Puerto Rico, or on corporations that undertake specific transactions, such as purchasing insolvent savings and loan institutions or investing in intangible assets. In some cases, new provisions will lead to changes in behavior. For example, the redesigned and scaled-back possessions tax credit gives some high-tech U.S. corporations in Puerto Rico an incentive to substitute labor for capital; other corporations might move their operations elsewhere. By contrast, the provision restricting tax benefits for firms that purchased insolvent

19. Jane G. Gravelle, "Effect of Current Tax Proposals on Employment in the Restaurant and Entertainment Industries" (Congressional Research Service, May 18, 1993).

savings and loan institutions before 1989 will not change the behavior of affected firms because the transactions have already occurred.

The possessions tax credit has allowed U.S. firms to reduce their taxes substantially by investing in U.S. possessions, most notably Puerto Rico. Many U.S. corporations, primarily manufacturing firms, undertake research in the United States that is then applied in production in Puerto Rico. The production is typically very capital-intensive; on average, possessions corporations have received U.S. tax benefits that have exceeded their entire wage bill in Puerto Rico.

OBRA-93 restricts the use of the possessions tax credit by capital-intensive corporations. The provision may reduce investment by U.S. firms in Puerto Rico, but it also may encourage capital-intensive firms that continue to operate there to hire more local employees. The net effect on employment in U.S. possessions is uncertain.

Estimated Payments. OBRA-93 increases estimated payments by requiring corporations to pay 100 percent of their expected annual tax bill as estimated payments through the year. The 100 percent estimated payment requirement is permanent. Under prior law, the required estimated payments were 97 percent of tax liability through 1996 and 91 percent beginning in 1997. The speedup in estimated payments accounts for about one-fifth of the total increase in corporate tax revenue between 1994 and 1998 but has little economic effect. Based on reasonable assumptions about the expected rate of return from deferring the payment of taxes, corporations faced an effective top rate of about 33.9 percent under prior law, which was not much different from the top statutory rate of 34 percent.

CHANGES IN INCENTIVES CLASSIFIED AS TAX EXPENDITURES

"Tax expenditures" are federal revenue losses arising from provisions in the income tax code that give selective relief to particular groups of taxpayers or special incentives for particular types of economic activity. Estimates of tax expenditures reflect the amount of revenue that the federal government forgoes as the result of these preferences, thereby indicating how much the government uses the tax code to further nonrevenue goals. On balance, OBRA-93 increases tax expenditures.

The Normal Tax Structure and Tax Expenditures

The concept of tax expenditures implies that the tax code has both normal and preferential elements. The normal tax structure includes an individual and a corporate income tax. For individuals, the normal structure includes general rate schedules and exemption levels, the standard deduction (or its equivalent), and general rules defining the taxpaying unit and setting forth accounting periods. For corporations, the normal structure includes a basic tax rate and deductions for ordinary and necessary expenses, but does not include graduated rates for corporations. Although graduated rates for individuals reflect society's judgment on how much tax people at different income levels should pay, graduated rates for corporations help some businesses without necessarily reducing rates for lower-income taxpayers.

For individuals, tax expenditures include deductions for mortgage interest, charitable contributions, and state and local income taxes; exemption of interest on state and local bonds; the maximum rate on capital gains; and many others. For corporations, they include rates below the maximum; tax credits for particular types of investment, such as research and experimentation; and accelerated depreciation of machinery and equipment.

Tax legislation can affect tax expenditures directly by changing specific tax preferences or indirectly by changing the normal tax structure--for example, by raising or lowering rates, altering the standard deduction or exemption levels for individuals, or redefining ordinary expenses for corporations. When the normal tax structure changes, some tax expenditures will rise or fall, even if the legislation makes no other changes to the tax code.[20]

The Provisions of OBRA-93

The effects of OBRA-93 on tax expenditures contrast sharply with the provisions of TRA-86. The latter reduced tax expenditures by lowering rates and cutting back or repealing many tax preferences. By comparison, OBRA-93 increases tax expenditures generally by raising the tax rates of higher-income households, and although it scales back some tax preferences, it also enacts some new ones and expands or extends others.

20. For a more detailed discussion, see Congressional Budget Office, *The Effects of Tax Reform on Tax Expenditures* (March 1988).

The Effects of Increases in Tax Rates

OBRA-93 changes the normal tax structure by increasing individual and corporate tax rates and making the phaseout of the personal exemption permanent. Even if all other provisions of the tax code remain the same, higher tax rates raise the value of tax preferences, thereby encouraging individuals and businesses to undertake more tax-favored activities. OBRA-93 increases individual income tax rates only for very high income individuals and increases the top individual rate much more than the top corporate rate. Consequently, the higher rates significantly increase the value of tax preferences that primarily benefit high-income individuals, but they only slightly increase the value of tax preferences that corporations and a broader group of individual taxpayers claim.

For example, the estimated revenue loss in 1994 from the maximum rate on long-term capital gains increases from $2.4 billion under prior law to $7.6 billion, even though the rate remains at 28 percent. The reason is that most capital gains are realized by high-income taxpayers and the capped rate on gains benefits only taxpayers above the 28 percent bracket. By contrast, the revenue loss for the deduction of mortgage interest increases only slightly in 1994, from $45.5 billion under prior law to $46.4 billion. For the same reason, the estimated revenue loss in 1994 from the deductibility of charitable contributions also increases moderately, from $16.9 billion under prior law to $17.9 billion.[21]

New and Expanded Tax Preferences

OBRA-93 provides new tax preferences and expands existing ones intended to stimulate investment in small businesses and in targeted low-income areas and to assist low-income wage earners (see Table 5).

Small Business Incentives. OBRA-93 increases some existing tax expenditures for small businesses and introduces new ones (see above).

21. The estimates under prior and current law are based on the same economic assumptions, which are from CBO's January 1993 forecast. The estimates compare revenue losses assuming the tax base and rates in prior law with revenue losses assuming the tax base and rates in current law.

TABLE 5. REVENUE EFFECTS OF TAX-PREFERENCE PROVISIONS IN OBRA-93
(By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Five-Year Total
Revenue-Reducing Provisions						
New or Expanded Preferences						
Capital gains incentives for investment in small businesses	a	-0.1	-0.2	-0.2	-0.3	-0.8
Incentives for investment in empowerment zones, enterprise communities, and Indian reservations	-0.3	-0.5	-0.5	-0.6	-0.6	-2.5
Increased expensing under Section 179 to $17,500 for taxable years beginning January 1, 1993	-2.3	-1.0	-0.7	-0.4	-0.2	-4.6
Expansion of earned income credit	a	0.2	-0.4	-0.5	-0.6	-1.7
Extensions of Preferences						
Permanent extensions						
Low-income housing credit	-0.4	-0.6	-0.9	-1.3	-1.7	-4.9
Mortgage bonds and mortgage credit certificates	-0.1	-0.2	-0.2	-0.3	-0.3	-1.0
Small issue bonds	a	a	-0.1	-0.1	-0.1	-0.3
Bonds for high-speed intercity rail facilities	a	a	a	a	-0.1	-0.1
Temporary extensions						
Deduction for health insurance for self-employed individuals through December 31, 1993	-0.6	0	0	0	0	-0.6
Exclusion of employer-provided educational assistance through December 31, 1994	-0.6	-0.3	0	0	0	-0.9
Targeted jobs credit through December 31, 1994	-0.3	-0.2	-0.1	a	a	-0.7
Orphan drug credit through December 31, 1994	a	a	0	0	0	a
Research and experimentation credit through June 30, 1995	-2.2	-1.2	-0.8	-0.4	-0.3	-4.9
Revenue-Raising Provisions						
Repeal or Limitation of Preferences						
Increase in depreciation period for nonresidential real property from 31.5 years to 39 years	0.1	0.3	0.6	1.0	1.4	3.4
Increase in taxable portion of Social Security and Railroad Retirement benefits	1.9	4.6	5.3	6.0	6.7	24.6
Reduction in compensation that can be taken into account for purposes of contributions and benefits under retirement plans	0.2	0.6	0.6	0.6	0.6	2.5
Denial of deduction for club dues	0.1	0.2	0.2	0.2	0.3	1.1

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Empowerment Zones and Enterprise Communities. OBRA-93 gives the Secretary of Housing and Urban Development authority to designate six empowerment zones and 65 enterprise communities in urban areas. It also gives the Secretary of Agriculture authority to designate three empowerment zones and 30 enterprise communities in rural areas. The designated areas must satisfy eligibility criteria, including specified poverty rates and limits on population and geographic size. For the most part, the designations will remain in effect for 10 years.

In the nine empowerment zones, the legislation makes available a 20 percent employer wage credit for the first $15,000 of wages paid to a zone resident who works within the zone; expanded tax-exempt financing for certain zone facilities; and up to $37,500 of current deductions, or expensing, for certain zone business property. The 95 enterprise communities are eligible for expanded tax-exempt financing, but not for the other preferences. The empowerment areas and enterprise communities are an outgrowth of earlier enterprise zone proposals, but the range of available incentives is more limited.

The act also provides for the next 10 years two tax incentives for all Indian reservations: enhanced accelerated depreciation for certain property used in a trade or business and certain related infrastructure property; and a 20 percent incremental employer wage credit for wages and health insurance costs, up to $20,000 per employee, paid to tribal members who work on a reservation and earn less than $30,000 a year. The credit is incremental and thus is available only if the sum of wages and health costs for any year exceeds the sum of comparable costs for 1993.

Earned Income Tax Credit. OBRA-93 expands the earned income tax credit by increasing the maximum credit available to taxpayers with one child, increasing over a three-year period the maximum credit available to taxpayers with two or more children, and extending the credit to childless taxpayers.

Bonds for High-Speed Intercity Rail Facilities. OBRA-93 removes all volume limits on the issuance of tax-exempt bonds for high-speed intercity rail facilities that are governmentally owned. Under prior law, 25 percent of each bond issue for high-speed intercity rail facilities, whether privately or publicly owned, had to be counted against the volume limits on a state's issues of bonds for private activities. OBRA-93 removes the requirement for publicly owned facilities, effective for bonds issued after December 31, 1993.

Extensions of Tax Preferences

OBRA-93 extends several tax preferences that had expired or were about to expire under current law (see Table 5). The practice in recent years has been to extend expiring tax preferences for brief periods, generally ranging between six months and a year and a half. Many temporary tax preferences have been extended several times over the last 15 years.

Permanent Extensions. OBRA-93 permanently extends some tax preferences that the Congress had several times renewed for short periods. These preferences include the low-income housing credit and the exemption from taxation of interest on qualified mortgage bonds and small issue bonds.

The low-income housing credit provides an incentive for individuals and corporations to invest in low-income housing. The credit, which is paid annually for 10 years, applies to expenditures for new construction and rehabilitation of low-income housing. Enacted as part of TRA-86 and subsequently modified in 1989, it replaced a variety of other incentives for investment in low-income housing, providing relatively more assistance to lower-income households than the incentives under prior law. OBRA-93 extends the availability of the credit to investments in housing receiving assistance under the HOME program of the National Affordable Housing Act of 1990.

Tax-exempt financing provides a means of borrowing at below-market interest rates. Mortgage bonds and mortgage credit certificates benefit first-time purchasers of single-family homes, provided their income and the purchase price of their homes fall below specified limits. Small issue bonds benefit manufacturers whose capital expenditures are below levels specified in the law and first-time farmers who invest in agricultural land or property.

Like some other tax preferences, the low-income housing credit and the tax-exempt bond provisions are similar in their intent and eligibility criteria to some spending programs. As with many spending programs, they require administrative oversight and incur overhead costs. These tax preferences also incur additional efficiency costs because some of their benefits accrue to investors in low-income housing and purchasers of tax-exempt bonds in the form of higher after-tax returns, instead of flowing entirely to low-income tenants as lower rents, or to homeowners, farmers, or manufacturers in the form of below-market interest rates on mortgages or other loans.[22]

22. For further analysis of the low-income housing credit, see Congressional Budget Office, "The Cost-Effectiveness of the Low-Income Housing Tax Credit Compared with Housing Vouchers," CBO Staff Memorandum (April 1992).

Temporary Extensions. OBRA-93 also extends several preferences for temporary periods, including the deduction of 25 percent of health insurance expenses for the self-employed, the exemption from income of employer-provided educational assistance, the targeted jobs tax credit, the tax credit for orphan drugs, and the research tax credit. All of these provisions had expired on July 1, 1992. The research tax credit will extend through June 30, 1995; the other preferences expire on December 31, 1994, except for the deduction of health insurance expenses, which expired at the end of 1993. OBRA-93 renews the targeted jobs tax credit for the ninth time since its original enactment in 1978; the exclusion for employer-provided educational assistance for the seventh time since its enactment in 1978; the research and experimentation credit for the sixth time since its enactment in 1981; the deduction for health insurance premiums paid by the self-employed for the fourth time since its enactment in 1986; and the orphan drug credit for the fourth time since its enactment in 1983.

The original purpose of making some tax preferences temporary was to subject subsidies delivered through the tax code to a review process similar to the appropriation and authorization process for spending programs. The extension periods for tax preferences generally ranged between three and five years. Over the years, the Congress has modified several programs, expanding some and imposing limits and tighter eligibility criteria on others. Although this process continues, the extension periods have become much shorter.

Recent short-term extensions reflect the incentives of the pay-as-you-go rules in the Budget Enforcement Act of 1990. Extending revenue-losing provisions for shorter periods allows the Congress to defer some of the offsetting deficit reduction that the rules require. Repeated renewal of a tax preference ultimately increases the deficit as much as long-term or permanent renewal, but estimates of revenue losses from short-term extensions effectively conceal this in the short run. Thus, for example, the estimated revenue losses from 1994 to 1998 from renewing the research and experimentation credit through June 30, 1995, are slightly less than $5 billion. The estimated revenue losses from permanent extension would have been about $10 billion between 1994 and 1998.

Repeal or Limitation of Tax Preferences

OBRA-93 also reduces some tax expenditures. Major items include making the limit on itemized deductions permanent, increasing the depreciation period for nonresidential real property from 31.5 years to 39 years, and increasing the taxable portion of Social Security and Railroad Retirement benefits. OBRA-93 also scales back a number of smaller corporate tax preferences (see the above section on effects on business organizations and industries).